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BREAKERMAG

We Haven’t Learned From the Financial Crisis—Just Look at Crypto

By Angela Walch

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Angela Walch is a professor of law at St. Mary's University School of Law in San Antonio, Texas, and a research fellow at the Centre for Blockchain Technologies at University College London. This is her first LAWBREAKER column.

This fall, we mark the 10-year anniversaries of two significant, and arguably related, events: the 2008 financial crisis and the creation of bitcoin. The bitcoin white paper was released on October 31, 2008, mere weeks after President George W. Bush signed the $700 billion bailout bill into law. Many have viewed bitcoin and other crypto-assets as antidotes to flawed institutions like banks and governments.

Ironically, 10 years later, there are many similarities between the world of crypto-assets today and the circumstances that led to the financial crisis. Though crypto-assets do not currently pose the same dangers as, say, mortgage-backed securities and collateralized debt obligations, there is potential to make similarly poor decisions around crypto-assets, enabling risks to grow and eventually become systemic.

This column describes six ways the current crypto-asset world mirrors the world a decade ago. At core, all these similarities relate to the failure to appreciate—or a choice to disregard—risk.

Leading up to 2008, investors failed to appreciate the risks associated with subprime mortgages. Similarly, many today fail to understand the risks from crypto-assets.

First, as with subprime mortgages before the financial crisis, there is a push to "financialize" a poorly understood, risky asset. There are significant efforts to integrate crypto-assets into the mainstream financial system, so institutional investors are able and willing to invest. Examples include the introduction of bitcoin futures by the Chicago Mercantile Exchange and the Chicago Board Options Exchange in 2017, proposals for bitcoin exchange traded funds, the creation of many stablecoins, the new Bakkt exchange from ICE and others, initiatives by Coinbase, BitGo, and others to act as crypto-asset custodians on behalf of institutions, and plans by Goldman Sachs and Morgan Stanley to offer crypto derivatives trading. All of these initiatives build on crypto-assets as the core underlying asset, just as many financial products incorporated subprime mortgages as an underlying asset before the crisis.

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For instance, we don't know how forks of a blockchain will affect complex financial infrastructures built on top. The governance structures of crypto-assets are experimental, yet we see little discussion of how governance flaws in the underlying asset could impact all financial structures connected to it. I see little mention of how bugs in the software code could affect every financial structure built on it, or how the existence of digital assets is reliant upon software developers and transaction processors, who are accountable to no one for their performance. Meanwhile, everyone appears to believe that state actors or well-funded terrorist organizations would not succeed in a 51 percent attack (a hostile takeover of a crypto-asset computer network).

Second, there is strong potential for regulatory "capture" in the crypto-asset space (when regulators serve the interests of those they regulate rather than the larger public good). This was a key driver of the financial crisis, as bankers cozied up to their overseers who missed the accumulating risks. There are numerous former regulators and policy-makers who are now part of the crypto-asset industry, including former Federal Deposit Insurance Corporation chair Sheila Bair (now on the board of Paxos and an advisor to Omniex), former Securities & Exchange Commission chair Arthur Levitt (now an advisor to BitPay and Omniex), and Mark Wetjen, formerly of the U.S. Commodity Futures Trading Commission (now on the advisory boards of Coin Center and the Digital Chamber of Commerce, two crypto advocacy groups).

Third, there is pressure on regulators and policy-makers to look like they are open to innovation. Because of the pressure to create jobs, they may underestimate the risks of new technologies like blockchain, given how widely it has been hyped. It is practically a religious mantra to say it will be as transformative as the internet, and regulators and policy-makers who stand in the way are seen as out of touch and responsible for driving wealth to other jurisdictions. We are already seeing regulatory competition develop, with Malta, Gibraltar, and Bermuda (and US states like Arizona and Wyoming) branding themselves as "crypto-friendly."

Fourth, crypto-assets, like credit default swaps that almost brought down Wall Street, are complex and opaque to all but a tiny set of experts. One needs expertise in cryptography, distributed systems, economics, finance, psychology, sociology, and history to understand some crypto-assets. As we learned with the Theranos scandal, smart people are willing to take the word of others on complex, opaque topics, without interrogating deeply.

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policy decisions.

Fifth, academic work surrounding crypto-assets may not provide a solid foundation for financial, regulatory, and policy decisions. The economics discipline was roundly criticized for its failure to foresee the 2007/8 crisis, and for helping to create it through flawed theories. In the crypto-asset academic arena, there are many articles that recite characteristics that crypto-assets don't necessarily have (like immutability, decentralization, that records inherently reflect 'truth').

Like a virus, once myths take hold, they spread until they are hard to counteract. Only now is academia beginning to wrestle with whether researchers should be able to own the crypto-assets they are studying, or to disclose ownership interests when they publish. Many academics act as advocates for this technology, serving as advisors to crypto start-ups and collaborating with industry lobbying groups. It is notable that many university research centers devoted to crypto-assets or blockchain have words like "initiative" in their titles. This suggests a predetermination that the tech *should* be pushed forward.

Sixth, as before the financial crisis, there is strong potential for groupthink around crypto-assets. The industry has shaped a seductive narrative, helped by organizations like Coin Center, the Digital Chamber of Commerce, the Global Blockchain Business Council, and the newly announced Blockchain Association. Prominent VCs like Andreessen Horowitz and Union Square Ventures, as well as the World Economic Forum, have acted as evangelists. There are few who question whether decentralization actually benefits society. Those daring to ask questions are branded as luddites, or as simply not getting it. This has meant that a full vetting of crypto-assets, the tech, and the human relations underlying them, has not yet happened.

Together, these factors create a perfect storm. For instance, the complexity and opacity of the technology can intensify the potential for regulatory and policy-maker capture. Cultural practices about risk exacerbate the problem, combining tech's 'move fast and break things' philosophy with finance's voracious appetite for risk, resulting in more hubris.

The risks relating to crypto-assets do not guarantee another financial crisis. But the similarities between then and now suggest there is much to fix in our approach across industry, academia, and among regulators and policy-makers. We need to be clear-eyed before incorporating these instruments into the global financial system. The stakes are high, and the decisions about the way forward will not be easy.

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